COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

PETITION FOR APPROVAL OF BASE RATE CHANGES FOR THE ELECTRIC AND GAS DIVISIONS OF FITCHBURG GAS AND ELECTRIC LIGHT COMPANY

D.T.E. 02-24/25

REPLY BRIEF OF FITCHBURG GAS AND ELECTRIC LIGHT COMPANY

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I. INTRODUCTION

Fitchburg Gas and Electric Light Company ("FG&E" or "the Company") submits this Reply Brief in response to the Reply Briefs of the Division of Energy Resources ("DOER Reply Br.") and the Attorney General ("AG Reply Br.") filed on October 17, 2002. FG&E's Reply Brief offers necessary clarifications and corrections to the assertions made by the intervenors on reply. FG&E also responds to new arguments raised by the Attorney General on reply, including the Attorney General's final recommendations concerning the Company's revenue requirement.[1]

Based upon final updates and adjustments provided during the course of the Electric Division proceeding, FG&E's total revenue deficiency is $4,011,566, which reflects a revenue deficiency of $3,531,553 for the distribution function and $480,017 for internal transmission.[2] Based upon the final updates and adjustments provided during the course of the Gas Division proceeding, FG&E's total revenue deficiency for the Gas Division is $3,452,405, which reflects a revenue deficiency of $3,418,271 for the distribution function and $34,134 for the gas production function.[3] While the Company recognizes that these revenue deficiencies are greater than FG&E's original request, the additional amounts reflect corrections, clarifications and updates provided during the course of this proceeding.

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[1] The Company has responded to the Attorney General's evidentiary objections and motion to strike in a separate pleading, submitted simultaneously with this Reply Brief.

[2] FG&E's final cost of service schedules, reflecting all updates and corrections made during the course of the proceeding, are provided as Attachments 1 (Electric) and Attachment 2 (Gas). The final updates for rate case expense and property taxes are included as Attachments 3 and 4, respectively.

[3] The final functional allocation between the Electric Division's distribution and internal transmission functions and the Gas Division's distribution and production functions will be performed at the time of FG&E's compliance filing in this proceeding, in accordance with the Company's allocated cost of service methodology study (Exh. FGE-JLH-1 at Sch. JLH-5) and the directives of the Department. During the course of this proceeding, the updates and adjustments to the revenue deficiency have been allocated to each function proportionately based on the revenue deficiency determined for each function as initially filed relative to the total revenue deficiency for the Electric Division and the Gas Division, respectively.

As FG&E documented through its initial filing, 1,000 responses to information and record requests and 15 days of hearings, the new rates are needed to support increased capital investments and rising business expenses during a period when customer and revenue growth has been generally flat or declining. This is only FG&E's second request for a base rate increase in 14 years, during which period the Company decreased its base rates on three occasions.[4]

In his reply, the Attorney General continues to extract data without testimonial support and to rely on isolated facts outside the context of the testimony or exhibits. FG&E has endeavored to correct the Attorney General's misstatements and omissions, and respectfully requests that the Department scrutinize the evidentiary foundation of each of the Attorney General's proposed adjustments in light of FG&E's responses thereto.

II. REVENUE REQUIREMENT

A. Rate Base

1. No Adjustment for the Princeton Paper Deposit Awarded by the Bankruptcy Court is Warranted

As a result of FG&E's diligent efforts to pursue recovery of pre-petition claims from Princeton Paper, the Bankruptcy Court allowed it to reclassify a $893,495 deposit and apply it towards the amounts owed by Princeton Paper for electric and gas service rendered by FG&E prior to the bankruptcy. Tr. 8/23/02 (Vol. 11) at 1310-1311; Exh. AG-2; Exh. AG-RR-1. The Attorney General offers no legal support for his claim that this deposit, which was appropriately applied to pre-petition amounts owed by Princeton Paper for electric and gas service, should now

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[4] The Company decreased its gas and electric rates in 1987 pursuant to a settlement with the Attorney General and Department directive regarding a change in the federal income tax rates See Investigation by the Department Into the Effect of the Reduction in Federal Income Tax Rates, D.P.U. 87-21-A (1987). The Company voluntarily decreased its gas and electric rates in 1993, in Fitchburg Gas and Elec. Light Co., D.P.U. 93-165 (1993) and reduced its electric rates in 2001 pursuant to the Department's Order in DTE 99-118.

be deducted from FG&E's rate base, and instead resorts to ad hominem attacks upon the Company's witness. AG Reply Br. at 2-4.

FG&E's settlement award on its pre-petition claims is neither a "windfall" for the Company nor "unfair to customers." Under the bankruptcy settlement, FG&E recovered amounts due from Princeton Paper for electric and gas service provided prior to the bankruptcy in 1999. Tr. 8/23/02 (Vol. 11) at 1310-1311. By successfully pursuing the recovery of its claims in the Bankruptcy Court, through application of a deposit, FG&E was able to avoid both a write off of the Princeton Paper pre-petition debt and an increase in bad debt expense that would have increased costs for other customers. Id. at 1314. Contrary to the Attorney General's assertion, in this case FG&E is not seeking to recover the pre-test year write-off of the Princeton Paper obligations, since it was never required to write off these amounts due to its successful effort to use the deposit that it held to offset amounts owed for electric and gas service.

The Department should reject the Attorney General's attempts to recast his cross examination of the Company's witness in D.T.E. 99-118. AG Reply Br. at 3. Putting aside the Attorney General's contextual omissions, Mr. Collin's responses in the June 2001 hearing were accurate at that time and are accurate today. Compare D.T.E. 99-118 at Tr. 2, pp. 297-298 (administrative notice taken) with Tr. 8/23/02 (Vol. 11) at 1310-1311. The bankruptcy settlement was not an order which altered in any way the terms of service for electric and gas service between FG&E and Princeton Paper, other than to confirm that FG&E's charges for service would have administrative expense priority pursuant to sections 503 and 507 of the Bankruptcy Codes, as testified to by Mr. Collin. Id.; see also Exh. AG-2. Exh. AG-2. The settlement did not, as the Attorney General asserts, reduce or eliminate the then applicable demand charges billed to Princeton Paper for service. Exh. AG-2. The settlement merely

allowed FG&E to recover pre-petition amounts owed the Company without altering the provisions for electric services with FG&E under its G-3 tariffs. Id.

The Attorney General's claims of nondisclosure are disingenuous given the context of the issues in D.T.E. 99-118 and the cross examination cited. In that case, the focus was on FG&E's proposed adjustment to omit the Princeton Paper revenues from the 1999 test year revenues. See DTE 99-118 at 14-20. As the Department recognized, Princeton Paper was a unique source of revenue for FG&E because of a significant demand charge which was billed to the customer during the 1999 test year under the terms of special contracts regardless of the amount of electricity the customer used. Id. at 17. In responding to the Attorney General's cross-examination on the actions of the Bankruptcy Court, Mr. Collin focused on the continuing obligation of FG&E to serve the customer, post-bankruptcy, and potentially obtain revenues from Princeton Paper. D.T.E. 99-118 (Tr. 2 at 297-298).

The Attorney General's assertion on brief that the Bankruptcy court "did, in fact, reduce or eliminate demand charges" is erroneous, and is exacerbated by the fact that the focus of the Attorney General's cross-examination was on Princeton Paper's ongoing revenue stream, not on pre-petition claims. Compare AG Reply Br. at 3 with D.T.E. 99-118 at Tr. 2, pp. 297-298 (administrative notice taken). In fact, the Court's order in no way altered or eliminated the demand charge for service being rendered by FG&E; it merely allowed FG&E to apply the construction deposit it held to its pre-petition accounts receivable from Princeton Paper. The Attorney General's proposals with regard to this matter should be rejected.

2. The Attorney General's Proposed Adjustment for the Sawyer Passway Substation Is Inequitable

During the test year, the original Sawyer Passway substation was in-service, along with a $5.2 million replacement substation. See Exh. FGE-MHC-1 at 022 (Electric). The Attorney

General's claim that the Department should make a post test year pro forma adjustment to remove the original Sawyer Passway from rate base is contrary to Department precedent and unsupported by the facts. See AG Reply Br. at 4. In 2002, FG&E has continued to make capital expenditures for the clean up and dismantling of the original substation, which has not yet been retired. Because this plant retirement process is neither unusual in nature nor extraordinary in amount, a post-test year adjustment is unwarranted. See Berkshire Gas Co., D.P.U. 92-210-B at 14 (1993); Boston Edison Co., D.P.U. 1300 at 18 (1983).

The Department's practice is to "adhere to the rate base structure as it occurred during the test year," because of the difficulty in identifying offsetting retirements and additions of plant. See Edgartown Water Co., D.P.U. 62 at 3 (1980). The Attorney General seeks to make a post-test year adjustment to rate base for plant which was in-service during the test year and is now in the process of being dismantled and retired. The ongoing retirement of the original Sawyer Passway substation is neither "unusual in nature," "extraordinary in amount" nor "significant" in relation to total rate base. Accordingly, pursuant to Department precedent, no post test year adjustment is warranted. See Kings Grant Water Co., D.P.U. 87-228 at 17 (1988).

If, however, the Department considers the Attorney General's suggestion to reach beyond the test year and exclude the original Sawyer Passway substation from rate base, then the Department must also consider other pro forma adjustments which would be required under appropriate regulatory accounting. FG&E Br. at 21-23.[5] The Department should, however, consider that the Attorney General's proposed adjustment would, under appropriate accounting and ratemaking, require corresponding changes to FG&E's depreciation reserve account to reflect

[5] The Department should reject the standard proffered by the Attorney General under which he is allowed to raise adjustments for the first time on brief, but the Company is subsequently prohibited from informing the Department of the implications that logically result from his proposed pro forma adjustment. See AG Reply Br. at 6.

cost of removal. Furthermore, removal of the original Sawyer Passway from utility plant in service would require a debit entry to the depreciation reserve of the same amount. These appropriate retirement journal entries would leave the undepreciated amount of $394,673 and the cost of removal in the depreciation reserve account. The rate base adjustment proposed by the Attorney General simply does not comport with appropriate utility plant accounting. The Attorney General offers no evidentiary or legal support for this deviation from standard utility accounting and ratemaking practice, and therefore his proposal should be rejected.

3. Amortization of the Capitalized Lease is Not in FG&E's Cost of Service

In his Reply, the Attorney General argues for the first time that FG&E failed to remove the amortization expense associated with capitalized lease from cost of service. AG Reply Br. at 23. The Attorney General is incorrect. There were no lease amortization expenses in the cost of service. FG&E reviewed the current accounting for the capitalized lease as reflected in the cost of service and the Department's precedent to treat such leases as operating leases for ratemaking purposes. DTE-RR-41. As a result of that review, as described below, FG&E proposes within DTE-RR-41 all appropriate adjustments to the test year cost of service.

The Company makes no adjustment to remove amortization expense associated with the capitalized lease because FG&E's review revealed that the amortization expense related to the capitalized lease was not included in its electric and gas transmission and distribution cost of service. Since the amortization expense was not included within the test year cost of service for either division, it did not need to be removed as the Attorney General recommends. See Attachment A, Sch. ADJ; see also Attachment A, Sch. MHC-7-19 (Electric) and Sch. MHC-7-22 (Gas).

4. FG&E's Proposed Cash Working Capital Allowance is Reasonably Calculated

In his Reply, the Attorney General claims that FG&E overstated its cash working capital allowance because it used the 45-day convention and states that FG&E failed to address the validity of the 45 day convention. AG Reply Br. at 8. This claim is incorrect. As part of its modified cost-benefit analysis, FG&E presented evidence about the expense lag days for a sample group of utilities. DTE-RR-64. FG&E's Electric and Gas division weighted average revenue lead days of 62.7 (Attachment DTE-RR-64, page 1, line 16) and the expense lags for the survey group of utilities (Attachment DTE-RR-64, page 2) results in a net lead/lag from the survey group of utilities that ranges from a low of 21.3 days and a high of 54.8 days. The mean is 40.2 days. DTE-RR-64. Based on this evidence, the Attorney General's suggestion that FG&E has no "need for any cash working capital for Other O&M expenses" is totally incorrect and unsupported by the record. See AG Reply Br. at 9.

The Attorney General also contends that FG&E's proposed 2.43 day meter to billing lag and two day funds collection to receipt lag should be zero. AG Reply Br. at 9. The Attorney General argues that the two day funds collection-to-receipt lag should be zero based upon the treatment accorded in Commonwealth Electric Co., D.P.U. 90-331 at 22 (1991).

FG&E disagrees. There have been many new developments and approaches in the banking and cash management field since this precedent was issued over ten years ago. The Department should apply the facts as they are known now and reflected on this record. See Exh. DTE-2-35. The record shows that customers are now relatively indifferent to the date payments are mailed to the utility company or the date that the company deposits their payment; instead they know their bank accounts' cash reserve line or a controlled disbursement account will be activated only at the time the respective check clears. Should the customer have funds in

their account at the time the check is written, they may be receiving the benefit of these funds up to the point that this check clears the account in the form of interest or reduced service fees. Id. Further, FG&E does not have use or availability of these funds until the check actually clears. Id.

FG&E believes that the proposed 2.43 day meter to billing lag should be includable. FG&E used this methodology in preparing its Lead/Lag Studies, which is substantially the same methodology recently accepted by the Department as reasonable to establish a 4.25 day meter to billing lag. Berkshire Gas Co., D.T.E. 01-56 at 51-52 (2002).

5. Accumulated Deferred Income Taxes Associated with Accrued Revenue Are Not a Guaranteed Source of Funds for FG&E and Would be Inappropriately Added as a Deduction to Rate Base

In his Reply, the Attorney General continues to claim that accumulated deferred income taxes associated with Accrued Revenues that FG&E deducted from its accumulated deferred income taxes in order to determine rates, should be added to the balance of accumulated deferred income taxes used for the distribution function. AG Reply Br. at 23-25.

The source of ADIT accrued revenues are the over- and under-collection balances from FG&E's energy-related reconciliation mechanisms. Exh. FGE-MHC-1 at Sch. MHC-11 (Gas and Electric). The net value of this account, over time, is and must be zero: it is a fully reconciling account, and by virtue of its reconciling nature, temporary. The "revenue" will continue to be volatile from year-to-year as the Department moves closer and closer to full transition in a restructured market. Since the accrued revenues are not predictable (either in level or amount from year to year), the ADIT associated with these accrued revenues are not a reliable nor guaranteed source of funds to FG&E. A permanent reduction to FG&E's distribution rate base should not be made for a level of funds that could be and will be reconciled, getting smaller and smaller toward zero, while being zero or even negative periodically along the way.

6. Additional Off-Sets to Rate Base For Customer Deposits

FG&E agrees with the principle that customer-supplied cost-free capital should, in general, be treated as an offset to rate base. See Hingham Water Co., D.P.U. 1590 at 10 (1984). Accordingly, the Company accepts the Attorney General's proposed adjustments to offset electric rate base by an additional amount of $176,123 for refundable customer advances and to offset gas rate base by an additional amount of $269,185 for refundable customer advances. These amounts were initially excluded from the Company's calculation of rate base, but are an appropriate offset under Department precedent. Exh. AG 7-9 (Electric); AG 5-9 (Gas). The Company also accepts the proposed offset for unclaimed funds which totaled $1,900 at the end of the test year. FG&E recommends that this offset be allocated based upon the G&E split of 69.09% (Electric) and 38.91% (Gas), resulting in an offset of $1,161 to the Electric Division rate base and $739 to the Gas Division rate base. Exh. FGE-MHC-1 (Electric) at Sch. MHC-4; Exh. FGE-MHC-1 (Gas) at Sch. MHC-4 (Gas).

B. Operating Revenue

1. The Department Should Reject the Attorney General's Post-Test Year Adjustment for Newark America.

In assessing proposed adjustments to test year revenues, the Department's fundamental inquiry is whether those test year revenues will, in fact, be representative of the Company's future revenues. Thus, the Department allows adjustments to historical test year data where there is a "known and measurable" change, which will result in an "extraordinary" impact on a Company's revenues, outside the normal ebb and flow. Fitchburg Gas and Elec. Light Co., D.T.E. 99-118, pp. 16-20 (2001); Massachusetts - American Water Co., D.P.U. 88-172, pp. 7-9 (1989); Western Massachusetts Elec. Co., D.P.U. 558, pp. 70-72 (1981). In the case of Newark America, the record clearly shows a large increase in that customer's load following the test year.

At the same time, the Attorney General has failed to demonstrate a corresponding increase in FG&E's post test year revenues to justify an adjustment for a single customer.

The Company agrees with the Attorney General that there has been a large increase in Newark's load in the most recent four months. See AG-RR-3 (confidential); Exh. AG-7-53 (Electric Supp.). However, Newark's growth is not indicative of a trend in FG&E's service territory, which has shown little growth. Tr. 8/19/02 (Vol. 8) at 944-945; Exh. AG-7-6 (Electric). The Attorney General, however, is incorrect in suggesting that the change in one customer's usage renders the test year level of revenues "unrepresentative." AG Reply at 11-12. Where, as in this case, a substantial increase in one customer's load does not result in a corresponding increase in the Company's revenues, then the test year levels continue to be representative and no pro forma adjustment is required. The Attorney General has failed to demonstrate that FG&E's 2001 revenue levels are unrepresentative and that the 2002 increases are outside the natural ebb and flow. Exh. DTE 2-9, Attachment at 1.

The record shows that FG&E forecasts no increase in large industrial customers during the next 3 years and that its load levels are not expected to reach the 1996 level of 520 million Kwh until 2006. Id.; see also Tr. 8/19/02 (Vol. 8) at 944. In fact, the Company's load forecast for 2002, which as the Attorney General points out, includes Newark America increases, will still be below the actual load in 1999. Exh. DTE 2-9, Attachment at 1. Accordingly, the Attorney General has failed to demonstrate that the growth in usage of one customer renders the 2001 test year revenues unrepresentative.

The Department rarely allows adjustment to test year revenues, generally finding that post test year changes do not rise to the level of extraordinary change outside of the normal ebb and flow. Fitchburg Gas and Elec. Light Co., D.T.E. 99-118, pp. 16-20 (2001); Massachusetts -

American Water Co., D.P.U. 88-172, pp. 7-9 (1989); Western Massachusetts Elec. Co., D.P.U. 558, pp. 70-72 (1981). The adjustment in D.T.E. 99-118 for Princeton Paper was based upon a unique contractual arrangement and significant revenue impact which suggested that the test year revenues were unrepresentative of future revenues. See D.T.E. 99-118 at 16-20. In fact, the 1999 test year electric distribution revenues were $15,521,040 compared to the 2001 test year electric distribution revenues of $14,371,980, or a 7.4% decrease. See D.T.E. 99-118 at 95; Exh. MHC-1 (Electric) at 2. In this case, FG&E's electric revenues in 2001 continue to be representative of the rate year because the increases in Newark America's base distribution revenues have been largely offset by the continuing erosion of revenues in FG&E's service territory. See Exh. FGE-MHC-1 (Electric) at 8; Tr. 8/19/02 at 941-45; Exh. DTE 2-9. The impact of Newark America's new load is neither extraordinary nor outside the ebb and flow routinely expected by the ratemaking process,[6] and thus does not warrant an adjustment to the test year revenues that continue to be representative of future revenue levels.

C. Operating And Maintenance Expense

1. Meter Removal

On Reply, the Attorney General reasserts his claim that FG&E inappropriately expensed the cost of removal for its meters, claiming a utility may only expense meter removal costs when the activity of "removing" the meter is conjoined with the activity of "resetting" the same meter for future use. AG Reply Br. at 25 (emphasis in original), citing the Uniform System of Accounts ("[t]he cost of removing and resetting meters shall be charged to [A]ccount 586, Meter Expenses").

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[6] The ebb and flow concept in regulation recognizes in balance that while the Attorney General can point to post-test year contributions to revenues right now, large customers unfortunately come and go from the system and the revenues they provide, that are factored into rates today, may no longer be available to FG&E to support the system. This has certainly been FG&E's experience. See Exh DTE 2-9, Attachment at 1. This refers to all large industrial customers, not just Newark America.

Consistent with its long-standing practice, FG&E interprets the Uniform System of Accounts to require that the "cost of removing meters" and the "cost of resetting meters" be charged to Account 586. The Attorney General provides no record evidence or legal authority for his rigid interpretation which would permit the expensing of meter removal costs only when the meters are also reset. Moreover, the argument is illogical because the phrase "removal and resetting" for future installation makes no sense. The Attorney General may be misunderstanding the term "resetting" to be a maintenance action that is performed on the meter itself, perhaps that the meter reading is "reset" to zero. In fact, the terms "setting" and "resetting" meters means, "installing" and "reinstalling" meters.[7]

Support is found in the Expense Account Instructions for Account 586, "Meter Expenses," in the Uniform System of Accounts.[8] The word "setting" refers to the installation of a meter, as there could be no other logical meaning. Furthermore, the important word to note is the word "first," as the "first" or initial installation of a meter is to be capitalized under Account 370. See fn. 7. Thereafter, any actions that remove or reinstall that same meter are expensed under Account 586.[9] This instruction is generally applied to devices, meters and others, that have long service lives and are routinely removed and reinstalled at other locations, rather than

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7 *RESET* (v): 1 : to set again or anew; 2 : to change the reading of, often to zero. Webster's American Dictionary (2002).

8 To be included under Account 586, Meter Expenses are:

> 3. Disconnecting and reconnecting, removing and reinstalling, sealing and unsealing meters and other metering equipment in connection with initiating or terminating services including the cost of obtaining meter readings, if incidental to such operation.
>
> 5. Changing or relocating meters, checking operation of demand meters and other metering equipment, when done as an independent operation

Note: The cost of the first setting and testing of a meter is chargeable to utility plant Account 370, Meters.

9 This is also consistent with certain other plant categories including line transformers, voltage regulators, and capacitors.

being retired upon removal. Utilities are generally allowed to capitalize the installation cost of these devices for *the first installation only*. At the time these devices are removed and reinstalled at other locations during their service lives, the associated costs are expensed.

The Department should note that this treatment is also consistent with the Operating Expense Instructions of the Uniform System of Accounts, which state that *maintenance expenses* shall include, under Item 4, rearranging and changing the location of plant not retired. For all these reasons, the Attorney General's proposal should be rejected.

2. The Non Union Wage Adjustment Is Reasonable And Should Be Approved As Proposed.

The Attorney General argues on reply that FG&E did not provide substantive record evidence about its compensation structure and attacks information provided by FG&E as unsupported. AG Reply Br. at 17. This argument has no merit. FG&E provided extensive information regarding its salaries, wages and compensation structure. FG&E Br. at 57; Exh. AG-5-11 (Gas, Electric, Common); Exh. AG-5-12 (Gas); Exh. DTE -4-5 (Common) (Confidential); AG-RR-7; Exh. FG&E-Surveys; Exh. FGE-MHC-1 at 036-41 (Gas); Exh. FGE-MHC-1 at 039-044 (Electric).

The Attorney General reiterates that FG&E's "combined wage and benefit package greatly exceeded both the industrial and utility averages." AG Br. at 30; AG Reply Br. at 18. FG&E stands by its initial brief for its response. FG&E Br. at 56. While the Attorney General espouses that the Hay Group findings show that FG&E's total benefit program was significantly higher than the median for the top two wage earners at FG&E, the fact is that these two senior executives are Unitil, not FG&E, employees and have total compensation (salary plus benefits) that is below the median. Compare AG Reply Br. at 18 with Exh. DTE-4-5 at 16 (Unitil "Current" vs. "Median"). Indeed, this table shows total remuneration for these executives (at and

above 960 Hay points) was below the 10th percentile (i.e., the bottom of the market). Id. Further, while the Attorney General is correct that the AGA survey shows that 3 out of 5 jobs at FG&E were above the AGA median when compared to small gas companies nationwide, the same table shows 3 of 5 jobs were below the median in the same survey when compared to gas companies in New England. Exh. DTE 4-5 at 16.

Finally, with regard to the Attorney General's proposed remedies,[10] FG&E would state that its adjustment for non-union salaries and wages is both reasonable and supported by the evidence. FG&E has already taken comprehensive steps to reduce benefits as part of the rebalancing of its total compensation structure and no adjustment is warranted based on the record.

3. The Proposed Medical And Dental Expense Increase is Known and Measurable and Reasonable

The Attorney General argues FG&E's proposed increase in medical and dental expense is not known and measurable because it is based on "unreliable" estimates provided by the insurance carrier, Anthem, and that the increase is unreasonable in relation to the forecast in the PBOP actuarial report. AG Br. at 20. The Attorney General's argument should be dismissed. The Department has determined that claims studies based on historical information are reliable for establishing known and measurable increases to test year insurance expense. See Essex County Gas Co., D.P.U. 87-59 at 39 (1987). The record demonstrates that Anthem's projected analysis of 2002 medical expense is reliable and reasoned in light of actual experience through July 2002, the 2002 projection is based upon the historical pattern and level of claims and is issued by a carrier that held FG&E's medical insurance program for many years prior to FG&E

[10] The Attorney General suggests the Department adjust the benefit levels of two wage earners who are Unitil employees and are not reflected in the wage adjustment See AG Reply Br. at 18. Obviously this mismatch is without merit and should be dismissed.

converting to self insurance. Tr. 8/19/2002 (Vol. 8) at 970; DTE RR-63. Anthem has first-hand experience with historical claims experience for FG&E. Tr. 8/19/2002 (Vol. 8) at 972.

The Attorney General's next recommendation, that the Department adopt an actuarial estimate to calculate the medical expense for current employees, is without merit. AG Reply Br. at 20. The estimate is derived from a FG&E PBOP actuarial report that uses a long term prediction of claims for future retired employees under a PBOP valuation. AG-RR-62. Not only is this a more tenuous estimate with no record support for its application in this manner, there is no record evidence that this estimate is related in any way to the actual claims experience for active employees.

The Attorney General also argues that Anthem's fee is based on estimated claims and that there is incentive for Anthem to inflate its claims estimate. AG Reply Br. at 19-20. In fact, Anthem's fee is not based on estimated claims but on a fixed amount per person insured. FG&E Br. at 62; DTE-RR-63, Attachment 4. The Attorney General's argument is not supported by the record and should be dismissed.

Finally, the Reply claims that "true-up" information regarding FG&E's medical self insurance plan costs is based on estimated claims payments, not on actual claims paid to the underlying medical providers. AG Reply Br. at 20, fn. 19. This is not correct. The "true-up" shows "estimated claims payments" and "excess claims" which were also paid. Exh. AG-1-63 (Electric) at lines (a), (b). The total of the "estimated claims" and the "excess claims" equals the total actual claims which were paid. Id. This is Anthem's standard billing practice. The Attorney General's argument should be rejected.

4. FG&E's Known And Measurable PBOP Expense Should Be Allowed In Cost Of Service

On Reply, the Attorney General argues for exclusion of PBOP expense from cost of service by focusing on whether cash contributions are made to a tax deductible trust.[11] AG Reply Br. at 19. However, FG&E's contributions to the Unitil Retiree Trust ("URT") clearly meet the Department's standard as tax deductible contributions, so the Attorney General's position with regard to these contributions has no merit. See FG&E Br. at 64, citing Massachusetts - American Water Co., D.P.U. 95-118 at 105 (1995); Massachusetts Electric Co., D.P.U. 92-78 at 83 (1992).

With regard to FAS 106, FG&E is required to accrue the cost of the PBOPs. Tr. 9/4/2002 (Vol. 12) at 1057. Accrual expense has been allowed for this Company by the Department in the past and should not be disallowed here. FG&E Br. at 66; D.T.E. 98-51 at 157; D.T.E. 99-118 at 57. The Company has minimized the costs associated with the establishment of a trust, while ensuring that employees of the Company continue to receive their post retirement benefits. FG&E's FAS 106 accrual expense and URT expense in cost of service should be approved as proposed.

5. The Department Should Grant FG&E's Proposed Pro Forma Adjustment To Property and Liability Insurance Expense

The Attorney General suggests that FG&E takes lightly its obligation to contain costs with regard to its property and liability insurance (AG Reply Br. at 13) and dismisses FG&E's justifications for the insurance increases it faces and its well-documented cost containment efforts. Id.; See Tr. 8/23/02 (Vol. 11) at 1385 - 87; Tr. 9/6/02 (Vol. 13) at 1561-64.

[11] The AG Reply Brief erroneously refers to the 2002 URT contribution as "estimated." AG Reply at 19. As the Department is aware, the Company filed under motion a certificate from its corporate secretary evidencing the May 2002 Board of Directors vote authorizing 2002 URT funding in response to the Attorney General's claim. Exh. FGE-URT Board Vote The Department is free to weigh this evidence along side of Exh FGE-MHC-1 at 048 (Electric) and Exh. FGE-MHC-1 at 042 (Gas), where Mr Collin incorporates his personal knowledge of the 2002 URT payments into the pro forma cost of service.

The record plainly examines: (1) the current state of the insurance industry and associated increased level of insurance premiums, that impact all insurance carriers; and, (2) the market for insurance in general. FG&E Br. at 68, citing Tr. 8/23/2002 (Vol. 11) at 1385-86; Tr. 9/6/2002 (Vol. 13) at 1561-1564. It is this general hardening of the current market that is driving expense increases and eliminating the potential for reduced costs. Compare id. with AG Reply at 13. Issuing an RFP for insurance involves cost - FG&E controls costs by issuing RFPs cyclically. Cost containment efforts implemented regularly and routinely as a matter of business practice and judgment should not be discounted simply because they are cyclical and did not happen to take place during the test year. FG&E Br. at 68.

Moreover, the evidence demonstrates that in those years when RFPs are not issued, FG&E uses the services of a broker to reduce insurance expense by assessing the market and the potential for reduced premiums and by recommending alternative carriers. FG&E Br. at 69 citing Tr. 8/23/2002 (Vol. 11) at 1388.

The Department should dismiss the Attorney General's arguments and allow the pro forma insurance expense as proposed by FG&E for the Electric Division and the associated broker's fee.

6. The Attorney General's Arguments Regarding Bad Debt Expense Should Be Dismissed.

On Reply, the Attorney General continues to claim that FG&E incorrectly recorded write-offs for the test year. AG Br. at 21-23; AG Reply Br. at 14-15. If approved, the Attorney General's position would change standing Department precedent without justification.[12]

[12] The Attorney General's core argument continues to be that FG&E "stockpiled extraordinary amounts of gross write-offs in the last month of the test year, avoiding the recognition of possible recoveries that may occur in the following month(s) in the next year." AG Reply Br at 15. Basing his pro forma adjustment upon this unfounded allegation, the Attorney General inexplicably ignores Department precedent that requires a full recent three year period of actual write-offs net of recoveries in the calculation of the bad debt adjustment. AG Reply Br at 15

FG&E fully explained the reasons for the level of net write-offs during the test year. Contrary to the Attorney General's argument, FG&E did not implement "monitoring" efforts when the arrearage problem arose during the test year, 2001, but continually engaged in collection activities throughout the year to reduce the level of bad debt expense. Compare AG Reply Br. at 15 with FG&E Br. at 73. FG&E has enhanced internal programs to expedite the review of delinquent accounts early-on in order to reduce the level of bad debt. FG&E Br. at 73. Collection efforts and potential recoveries do not begin at the time of write-off, they begin and are continued throughout the year until it is determined that FG&E is unable to collect the arrears. See Exh. AG-1-71; Tr. 9/6/02 (Vol. 13) at 1558-1559. Only after these efforts are exhausted, and the potential for recovery assessed, does FG&E determine that additional write-offs for the year are necessary, as directed by FG&E's external auditors. Id.; FG&E Br. at 73. This is the process that took place in the test year. Tr. 9/6/02 (Vol. 13) at 1558-1559.

The Attorney General's arguments are unsupported and contravene the Department's precedent and methodology for calculating bad debt expense. In light of the record, FG&E's bad debt expense calculation should be adopted to establish rates in this proceeding.

7. Service Corp. Interest Expense is Appropriately Included as Part of Service Corp. Expense to Affiliates.

In his Reply, the Attorney General reiterates his concern that FG&E ratepayers should not pay interest expense borne by Unitil Service Corp. as part of USC's operating expense. AG Reply Br. at 26-27. The Attorney General's position is that because FG&E recovers its own interest expense "in the form of a return on rate base," FG&E's ratepayers should not pay for USC's interest expense. Id.

The argument reflects a basic misunderstanding. USC is not FG&E. It is a separate corporate entity with no rate base. It is a third-party vendor of services to FG&E, and its

relationship with FG&E is supervised. M.G.L. c.164 §§76, 76A. USC is not rate regulated, but it can only charge FG&E at cost. Exh. AG-1-26 (Common) (USC Service Contract); Public Utility Holding Company Act §13(b); 15 U.S.C. §79m(b); 17 C.F.R. §250.90(a), 17 C.F.R. §250.91(a). Its interest expense is an obvious and necessary part of its operations and is appropriately calculated at cost into the charges invoiced to the purchasers of its services. FG&E purchases its services. Exh. AG-5-13 (Electric); Exh. AG 7-16 (Gas); Exh. DTE 3-5; Exh. DTE 3-6. The Attorney General has given no reasoned rationale for extracting and excluding this expense. The recommendation is the equivalent of taking the costs from all vendors and extracting their respective interest expense from allowed recovery. None of these vendors recover this reasonable business cost from any other source than the purchasers of their goods and services.

The Attorney General's arguments continue to be without merit and should be dismissed.

8. The Revenue Allocator Should Be Used for All Miscellaneous Accounts and Pro Forma Adjustments to Ensure Allocations between Utility/Non-Utility.

The Attorney General objects to FG&E's request to use the revenue allocator for all other accounts not directly allocated between utility and non-utility functions and for pro forma adjustments. AG Reply Br. at 22, fn. 21. The Attorney General claims that FG&E "does not even specify which portions of which accounts would be affected," however, a review of the Cost of Service Study demonstrates how and which accounts are affected. The Cost of Service Study demonstrates how the revenue allocator would allocate to non-utility functions.

The Attorney General suggests in footnote that FG&E failed to properly allocate medical and dental expense to non-utility operations. AG Reply Br. at fn. 21. This is incorrect. The record evidence demonstrates that FG&E did properly allocate medical and dental expense to non-utility operations. Exh.-MHC-7 (Gas) at p. 6 (Bates P. 351); Exh.-MHC-7 (Electric) at 6

(Bates 343)(all 926 subaccounts, such as health and dental insurance account 926-03 and 926-03-01, were properly allocated along with the many other employee benefit costs).

9. Routine and Customary Update - Inflation Rate Factor.

Consistent with the presentation provided by FG&E, the inflation rate factor applied to other O&M expenses has been updated for changes in forecasted GDPIPD indices that took place during the course of this proceeding. The update to this factor at the end of a rate proceeding is expected, and is a normal, routine, and customary calculation. Berkshire Gas Co., D.T.E. 01-56 at 36 (2002); see Blackstone Gas Company, D.T.E. 01-50 at 21-22 (2001); see also Berkshire Gas Company, D.P.U. 92-210, at 43 (1992); see also Massachusetts Elec. Co., D.P.U. 92-78 at 58-62 (1992). Accordingly, FG&E seeks approval of the inflation rate factor as updated on Attachment A, Sch. ADJ and Sch. MHC-7-12 (Electric), Sch. MHC-7-15 (Gas).

10. The Attorney General's Arguments Regarding FG&E's Incentive Compensation Plan Should Be Dismissed.

The Attorney General reiterates his argument on Reply that FG&E has changed the goals relating to USource/new business and Core Utility Earnings during the test year. AG Reply Br. at 21. FG&E already responded to this argument: it did not change the goals within the Incentive Plan during the plan year. FG&E Br. at 96; Exh. DTE-4-9 (Common); Tr. 9/6/02 (Vol. 13) at 1609-1611. In Exh. DTE-4-9 (Common), Attachments 1 and 2 show the goals for the year 2000 for all employees and then for management. Exh. DTE-4-9 (Common); Tr. 9/6/02 (Vol. 13) at 1610-1611. Attachment 3 shows the goals for 2001. Tr. 9/6/02 (Vol. 13) at 1610-1612. The goals did not change during the plan years; rather, the goals were appropriately reallocated based on business judgment in 2001, for all the reasons set forth in the record. Tr. 9/6/02 (Vol. 13) at 1608-1620.

The Attorney General contests that a change related to the Core Utility Earnings acted to normalize earnings, claiming for the first time on Reply that the Company does not justify using a normalized approach and that such changes undermine the incentive aspect of the plan and mislead employees. AG Reply Br. at 20-21. Weather normalization adjustments are integral to utility ratemaking and rate design and the Core Utility Earnings goal is normalized for weather in recognition of the obvious fact that weather is beyond the control of employees. Tr. 9/6/2002 (Vol. 13) at 1613. The Attorney General's concern would be valid if the Core Utility Earnings goal were not weather-normalized and the level of incentive awards in any year for this measure were left to the vagaries of weather.

11. Routine and Customary Update - Rate Case Expense.

Consistent with the presentation provided by FG&E, and the Hearing Officer's Ruling regarding consistent and regular updates of rate case expense throughout the proceeding, the updated schedules include Rate Case Expense through to the date of filing this Reply Brief. See Attachments 1 and 2, Sch. ADJ (Electric) and (Gas); Attachment 3; Sch. MHC-7-13 (Electric), Sch. MHC-7-16 (Gas); see also Exh. DTE-2-15. The update to this expense at the end of a rate proceeding is expected, and is a normal, routine, and customary calculation. Berkshire Gas Co., D.T.E. 01-56 at 36 (2002); see Blackstone Gas Company, D.T.E. 01-50 at 21-22 (2001); see also Berkshire Gas Company, D.P.U. 92-210, at 43 (1992); see also Massachusetts Elec. Co., D.P.U. 92-78 at 58-62 (1992). Included in FG&E's rate case expense are the expenses through to the filing of compliance rates in this proceeding, a known event. In order to ensure it meets the Department's prior directives requiring rate case expense to not be "estimated," but known and measurable, FG&E has taken the added step to negotiate fixed fees for the activities of each of its consultants that are necessary to conclude this proceeding. The fixed fees are included in letter invoices attached to the update. Accordingly, FG&E seeks approval of its updated rate case

expense as updated on Attachments 1 and 2, Sch. ADJ (Electric) and (Gas); Attachment 3; Sch. MHC-7-13 (Electric), Sch. MHC-7-16 (Gas).

The Department should note that FG&E has not estimated any additional expenses, or sought fixed fee assurances, from the vendors who assisted in creating FG&E's PBR plans for its Electric and Gas Divisions. These amounts are expected to be significant in the rate year.

D. Property Taxes

Consistent with the presentation provided by FG&E and Department precedent, the updated schedules include Property Tax expense updated through the date of filing this Reply Brief. See Attachments 1 and 2, Sch. ADJ (Electric) and (Gas); Attachment 4. The update to this expense at the end of a rate proceeding is expected, and is a normal, routine, and customary calculation. Berkshire Gas Co., D.T.E. 01-56 at 36 (2002); see Blackstone Gas Company, D.T.E. 01-50 at 21-22 (2001); see also Berkshire Gas Company, D.P.U. 92-210, at 43 (1992); see also Massachusetts Elec. Co., D.P.U. 92-78 at 58-62 (1992). Accordingly, FG&E seeks approval of its property tax expense as updated, and supported by bills provided at Attachment 4.

E. Amortization Expense

The decisions on the appropriate time periods for software amortization for FG&E's Gas and Electric Divisions have been based on technical and operational judgment as to the useful life of the particular software applications. Tr. 8/7/02 (Vol. 3) at 337-343, 359-366; Tr. 8/19/02 (Vol. 8) at 908-909, 918. Based on this approach, FG&E has determined its current computer software applications have amortization periods of 36, 60, 84, or 120 months. Exh. AG 7-65 (Electric); DTE-RR-4. These amortization periods reflect the appropriately determined useful lives of the specific computer software applications. Id.; Tr. 8/7/02 (Vol. 3) at 337-343, 359-366; Tr. 8/19/02 (Vol. 8) at 908-909, 918. The "consistency" issue raised by the Attorney General in reality relates to the process of determining the useful life of each software

application, not the amortization periods resulting from this process [13] The useful life determination process in this area has been recognized and accepted by the Department for many years. See, e.g., Massachusetts Elec. Co., D.P.U. 95-40 at 63 (1995).

FG&E has addressed the Attorney General's concern with use of 36, 60, and 84 months in the above paragraph. FG&E Br. at 100. However, the time periods of 55, 73 and 89 months are the remaining useful lives for certain software applications.[14] Compare AG Reply Br. at 16 with DTE-RR-4; Tr. 8/7/02 (Vol. 8) at 918-923. Regarding the Attorney General's disagreement with no amortization expense being recorded in the year of purchase or upgrade of certain software projects, it is common practice for expenditures to be made for physical assets in one period and for the in-service date to occur in a subsequent period. Such a point need not be belabored: depreciation of such assets' costs commences in the period of the in-service date, not the period of the expenditures in accordance with generally-accepted accounting principles and appropriate ratemaking treatment. In recognition of this practice, the Department's chart of accounts includes the account, "construction work in process."

The Attorney General states that some "discrepancy" exists for the commencement of the amortization on FG&E's customer information system ("CIS"). AG Reply Br. at 16. However the record indicates five times that the CIS in-service date was 1998. Tr. 8/19/02 (Vol. 8) at 911 ("went live with it on March 1, 1998[]"); Tr. 8/9/02 (Vol. 8) at 918 ("[a]mortization began in '98 []"); DTE-RR-4; Exh. AG-7-5 (Electric); Exh. AG-7-65 (Electric). These five citations include

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[13] A similar process takes place within depreciation studies, in the determination of useful lives of depreciable physical assets. The natural result of that process is the differing useful lives for individual physical asset classes, which is similar to the different useful lives of software projects.

[14] The last 2 items listed on Exh. AG 7-65 (Electric) are computer hardware, not software applications. There is another misunderstanding, when the Attorney General refers to Exh. AG 7-65 (Electric) as the "IBM Lease" and the 101 months of amortization. As described in that exhibit, the IBM lease is for computer hardware (specifically, the AS 400 Mainframe and Computer Equipment), not computer software, so the lease period would be based on the lease life for computer hardware and not the useful life for computer software.

the three citations used by the Attorney General to allege the existence of a discrepancy. Indeed, there is no indication of the existence of a discrepancy within his three citations. AG Br. at p. 24.

In his Brief, the Attorney General asserts that the costs of software and technology assets are not accurately allocated among all affiliates that use or otherwise benefit from these software assets. AG Br. at 25. The Attorney General specifically focuses on the CIS, which Mr. Collin testified was used by employees of USC and the other affiliated companies. Id. The cost of the CIS, developed by USC for the benefit of the three regulated entities, is charged to each of the companies that use the CIS. Tr. 8/9/02 (Vol. 14) at 1770-1771. The CIS was designed and developed for managing information related to the customers of the distribution companies. Tr. 9/9/02 (Vol. 14) at 1771. USC employees use the CIS in providing customers service to each of the distribution companies. Tr. 9/9/02 (Vol. 14) at 1771-1772. Therefore, the cost of the CIS is reasonably allocated to the distribution companies.

In addition, in his Brief the Attorney General refers to the cost allocation of the software and other technology assets among affiliates. AG Br. at 24. These costs, in addition to CIS costs, are allocated through the USC charge to affiliates. The Company has already described how the USC charge is allocated among the affiliates. FG&E Br. at 75-76; Exh. MHC-5 at 3 (indicates a line item, Amortization, within the category Overhead, which is a component of the Total Expense of USC chargeable to affiliates). The details of Amortization include CIS and various software and technology assets. Exh. AG-7-65 (Electric). Therefore the costs of these software and technology assets to which the Attorney General is referring are included in the costs charged to affiliates.[15]

For all these reasons, the Attorney General's recommendation should be denied.

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[15] Finally, the Attorney General incorrectly references DTE-RR-24; this request responds to the "peak-season bill impacts of the new CGA that will be filed September 16th."

III. RATE STRUCTURE, RATE DESIGN, AND TARIFF ISSUES

A. FG&E'S Use Of Design Day Allocation Of Gas Cost Is Appropriate

In his Reply, the Attorney General continues to argue that FG&E's use of design day allocators is contrary to principles of cost causation, does not replicate either the market or capacity assignment and may make the CGAC "unreviewable." AG Reply Br. at 41. In fact, FG&E's design day methodology matches the method used to assign capacity to marketers and suppliers, is fully appropriate for use in an unbundled environment. D.T.E. 98-32 (mandated method to allocate capacity). FG&E, by matching the CGAC and assignment methodology, is minimizing the impact on customers who are firm sales customers of the Gas Division. This treatment is identical to that used in D.T.E. 01-56, which was duly reviewed by the Department and accepted.

B. DOER Is Reasoned In Its Recommendation That The Department Match Customer Charges To The Cost To Serve

While DOER's recommendation contravenes FG&E's initially filed position regarding the level of customer charges, FG&E believes they are reasoned in their policy analysis and accurate in their calculations.

C. FG&E's Allocation of Bad Debt to DS and SOS is Appropriate

The Attorney General complains that attributing bad debt to DS and SOS may be appropriate so long as "certain necessary provisions are formalized to ensure an accurate allocation" of payments. AG Reply Br. at fn. 39. In order to resolve this outstanding concern, in light of the Department's Order in D.T.E. 01-28, FG&E will allocate proportionately partial payments to delivery service and supply service (DS and SOS). This is the same as the arrangements made with suppliers, and is consistent.

D. DOER Agrees With FG&E That The Marginal Cost Studies Are Useful

FG&E and DOER agree with regard to the use and sufficiency of the Company's marginal cost studies. However, DOER unnecessarily questions the basis of the Gas Division marginal cost study that was completed under a methodology previously reviewed and approved by the Department on multiple occasions. FG&E Br. at 124. Both the Gas Division and Electric Division Marginal Cost Studies are a sufficient basis upon which to determine marginal cost for the purposes of this proceeding. FG&E Br. at 116-128.

E. The Attorney General's Proposed Modifications To The CGAC and FG&E's Terms and Conditions

The Attorney General offers a completely new argument on his reply when he advocates modifying the CGAC to make very specific, detailed, wording changes to FG&E's tariff. AG Reply Br. at 49-53. The limited changes proffered by FG&E to its approved CGAC tariff is related to changes to the recovery of local gas costs and to reflect a modification to the Market Based Allocation Methodology. FG&E Br. at 136. The Attorney General's arguments go beyond this issue to questions of methodology and extend out of the record in this proceeding. The evidence does not support the extensive changes the Attorney General introduces on his reply brief and the suggestions are too detailed and too late in this proceeding to receive considered evaluation.

Furthermore, FG&E notes that the Terms and Conditions, to which the Attorney General has given such attention, were standard Terms and Conditions that came from the collaborative process under D.T.E. 98-32. All of these matters were determined with finality in an order of the Department approving language developed by multiple stakeholders including the Attorney General, over a long period of time. See D.T.E. 98-32-B; see also Fitchburg Gas and Elec. Light

Co., D.T.E. 00-20 (2001). The Attorney General's suggestions as to proposed modifications of FG&E's CGAC and Terms and Conditions should be dismissed.

IV. COST OF CAPITAL

A. The Attorney General Offers No New Arguments in Support of His Position on Short-Term Debt

The Attorney General admits that Department precedent requires that short-term debt be excluded from the calculation of a company's weighted cost of capital, but tries to distinguish FG&E based upon the observation that a "substantial portion of the Company's total outstanding debt is short-term debt." See AG Reply Br. at 33, citing Massachusetts Electric Company, D.P.U. 95-40 (1995). Department precedent that short-term debt should be excluded is clear, and is not tied to the percentage of short-term debt compared to a company's total outstanding debt. As short-term debt is already reflected in the calculation of a company's allowance for funds used during construction, it would be double counting to include short-term debt in the cost of capital calculation. See Massachusetts Electric Co. D.P.U. 95-40 at 84-85.

V. COST OF COMMON EQUITY

A. A One-Month Dip in Interest Rates Does not Warrant a Reduction in ROE

The Attorney General argues that the Department should approve a reduced ROE for FG&E due to the recent "tremendous drop" in interest rates that has occurred in the capital markets since FG&E's last rate case, D.T.E. 99-118. As Dr. Hadaway explained, the "tremendous drop" was in fact very small, and was largely a single month phenomenon that occurred in July 2002. Tr. 8/22/02 (Vol. 10) at 115 2-1155. Based upon the first six months of the year, Dr. Hadaway's analysis indicated the cost of debt was slightly over 8 percent. Although this number dipped by a few basis points to slightly below 8 percent in the month of July, this slight change in the interest rates did not warrant changing Dr. Hadaway's ROE

recommendations, given the Department's typical reliance upon six-month averages. Dr. Hadaway addressed this specific point on cross-examination.

> Q. And the reason for the reluctance to change in the face of falling rates is what?
>
> A. Number one, the change is very small. Number two, it is about a one-month event, mostly in the month of July, and typically we don't set rates based on one month's data or one day's data. If we look at the average for the first six months, for example, it is slightly lower, but only a few basis points lower than the three-month average that I have in my Exhibit 2, or my Schedule 2.

Id. at 1154. (emphasis added) Thus, the Department should reject the Attorney General's proposal to reduce FG&E's ROE based upon a few basis points dip in interest rates that had no material impact upon the cost of debt used in Dr. Hadaway's analysis.

B. Dr. Hadaway's Comparison Gas and Electric Groups Are Reasonable

The Attorney General reiterates the argument that Dr. Hadaway's comparison groups are inappropriate for establishing an ROE for gas and electric distribution companies. AG Reply Br. at 35-37. The Attorney General attacks the validity of Dr. Hadaway's comparison group on grounds the companies in the comparison group include utilities that have other non-regulated businesses and face different business risks than a utility distribution business. AG Reply Br. at 35-37. However, in D.T.E. 99-118, the Department endorsed Dr. Hadaway's comparison group which was based upon essentially the same methodology used here, and rejected the Attorney General's criticisms that the investment risks of the companies in the comparison group were not a good match for FG&E. In that case, the Department acknowledged that there is no such thing as a "perfect match" in a comparison group of companies, and stated

> Companies often use comparison groups, or groups of similar distribution companies, as a basis of comparison in order to evaluate their cost of equity analyses. The Department may accept the use of a comparison group when a company's stock is not publicly traded. Companies considered for a comparison group must have common stock that is publicly traded and must be of generally similar investment risk. Because of the range of operating conditions present in the electric industry, including those raised by restructuring, it is impossible to find a group of utilities that match the subject

> company in every way. Therefore, an analysis must employ valid criteria to determine which utilities will be used in the comparison group, and provide sufficient financial and operating data to allow the Department to discern the investment risk of the subject company versus the selection comparison group.

DTE 99-118 at 79-80 (citation omitted, emphasis added).

The Department accepted Dr. Hadaway's comparison group in D.T.E. 99-118, finding that FG&E applied a reasonable set of criteria in selecting the comparison group. Id. In that case, the Department disagreed with the Attorney General's contentions that the inclusion of vertically integrated utilities in the comparison group in and of itself justified a finding of lower risk for a distribution-only utility. Id. The Department also found that FG&E provided sufficient financial and operating data in order to allow the Department to consider any differences between the investment risks of the comparison group and FG&E (e.g., information concerning fuel mix, customer mix and cash flow). Id. at 79.

Moreover, Dr. Hadaway has, in this proceeding, implemented improvements to the comparison groups he had used previously by eliminating the western utilities, and by restructuring both groups to include only those utilities that derive 70 percent of their revenue from regulated activities. These changes were specifically targeted to address the difference in risk between FG&E and the larger vertically-integrated utilities in the group:

> With respect to the [DCF] sample group there was concern in the prior case about some of the companies perhaps being more risky than [FG&E]. One thing we did to respond to that was to eliminate all companies in Value Line's west edition, the California companies, and other companies out there affected by the energy crisis and the power cost adjustment problems that have existed there more so than in other parts of the country so those companies are entirely eliminated.
>
> In the gas sample . . . we have restricted those companies to be those that for sure have at least 70 percent of the revenues coming from regulated activities, so that the issue of diversification and the things that are of some concern to people about utilities these days are addressed. It is also addressed that way in the electric testimony as it was last time.

Tr. 8/22/02 (Vol. 10) at 1129-1131.

The record evidence demonstrates that Dr. Hadaway's comparison group is reasonable. It is substantially the same as and arguably further improved from the group endorsed by the Department in D.T.E. 99-118. The Department should reaffirm its ruling in D.T.E. 99-118 and find FG&E's DCF comparison group is reasonable for Dr. Hadaway's DCF analysis.

C. The Attorney General's Focus on Historically Depressed Growth Rates is Misleading.

The Attorney General would have the Department focus on historically depressed growth rates for gas distribution utility companies during the past 10 years. AG Reply Br. at 38. However, the Attorney General has presented no evidence that gas utility earnings growth rate from the past 10 years are in any way indicative of what investors expect for the future. In fact, quite to the contrary as Dr. Hadaway explained, in the past 10 years gas and other utilities have experienced significant restructuring and transition charges that render comparisons to historical earnings rates over that period useless. Tr. 8/22/02 (Vol. 10) at 1218-19.

Similarly, the AG's arguments about utility growth relative to the overall economy, simply do not comport with longer-term economic facts. AG Reply Br. at 38. The Attorney General's statement that "generally recognized" long-term economic growth forecasts indicate 5.5% growth is again based on his selective use of economic data and forecasts. Id. Long-term inflation has averaged 3% and long-term real growth in the economy has averaged 3%-4%. As Dr. Hadaway explained, the combination of these rates indicates long-term nominal growth of 6%-7%, with a midpoint of 6.5%. Dr. Hadaway's projected DCF growth rates of 5.94%-7.17% closely comport with this range, and the 6.5% midpoint growth with the 5.14% dividend yield from Dr. Hadaway's DCF analysis clearly supports his 11.5% ROE recommendation (5.14% dividend yield plus 6.5% growth = 11.64% ROE). The Attorney General fails to acknowledge the longer-term rate of actual economic growth in the U.S., and inserts a rate of 5.5% without

any expert support. The Attorney General's growth rate criticisms of Dr. Hadaway's analysis should be disregarded.

D. Dr. Hadaway's Risk Premium Analysis is Reasonable.

Dr. Hadaway based his risk premium analysis on ROEs allowed by State Commissions. Exh.-SCH-1 at 025 (Gas) 030 (Electric). The Attorney General's claim that Dr. Hadaway "performed" two risk premium analyses based on the Standard and Poor's 500 stock index is misleading. AG Reply Br. at 39-40. Dr. Hadaway stated that he only "reported" the Ibbotson and the Harris and Marston risk premium results for perspective and that he did not rely on these studies or recommend their results as the basis for the Department's ROE determination. See Tr. 8/22/02 (Vol. 10) at 1133, 1203. Moreover, Dr. Hadaway's reference to these studies is based on their risk premium comparison of stock market returns to corporate bond interest rates, which are higher than the Government rates used in the Attorney General's CAPM "analysis," further demonstrating that the Attorney General's CAPM approach is incorrect. The Attorney General's claims should be disregarded.

VI. DEPRECIATION

A. Expert Judgment is Critical in Life Estimation

On reply, the Attorney General repeats his criticisms of FG&E's reliance upon the judgment of its expert depreciation witness, Mr. Aikman, in developing FG&E's proposed gas and electric depreciation accrual rates. AG Reply Br. at 29, 31. As FG&E stated in its initial brief, it is critical for a depreciation expert to apply business judgment and expertise to the historical data. FG&E Br. at 160-161. The Department has also repeatedly cautioned that a depreciation study must not rely solely upon statistical analysis, but should also rely upon the "judgment and expertise of the preparer." Berkshire Gas Co., DTE 01-56 at 92 (2002); DTE 99-118 at 50 (2000); DTE 98-51 at 77-78 (1999).

Mr. Aikman's testimony and depreciation study are replete with references to the importance of judgment and expert opinion in life analysis: Mr. Alex E. Bauhan, for example, the person who developed the Simulated Plant Record ("SPR") life analysis, stated in 1947:

> The method reads the past and not the future, and has no way of telling which patterns will be followed in the future. Neither the actuarial or any other statistical process can eliminate this dilemma. Only by the exercise of reasonable judgment, or by the passage of time, can a selection be made.

Exh. FGE-JHA-1 at 069; App. A, at 129-131 (emphasis added). Similarly, the 1971 Study published by the New York Department of Public Service states:

> The computer exercises no judgment, reflects no opinions or company policies and does not forecast the future. The computer programs are merely the results of applying certain mathematical formulae to a set of statistics obtained from accounting records -- and, based on those data and formulae, give an indication of what has been the retirement experience of the past and what would be the future life pattern if the same experience were constant over the entire life of the surviving property under study.
>
> Under no circumstances should it be construed that a specific indicated service life and life table developed by this computer process must necessarily be used as the life table and average service life in arriving at a final estimate of annual and accrued depreciation. Stress is placed on the fact that the selected life table and average service life . . . must be the engineers' best estimate for the property under study.

Id. at 068 (emphasis added).

B. The Changes in Average Service Lives Since the Last Rate Case Are Valid

As the depreciation expert in these proceedings, Mr. Aikman applied his expert judgment and analyzed the statistical and SPR data to develop depreciation accrual rates for the gas and electric divisions of FG&E. It was Mr. Donoghue's task to conduct a similar analysis for FG&E's gas division in D.T.E. 98-51. Contrary to the Attorney General's criticism, FG&E has not arbitrarily substituted the judgment of one expert for another. Mr. Aikman confirmed that he reviewed the D.T.E. 98-51 study in the course of his preparations for the current study, in addition to performing his own independent analysis of the data. Tr. 8/6/02 (Vol. 2) at 237. Moreover, the following comparison of significant gas plant accounts refutes the Attorney

General's claim that there are vast discrepancies between Mr. Aikman's current study and the Department's findings in D.T.E. 98-51:

Account Number	Estimated ASL, yrs. D.T.E. 98-51	Estimated ASL, yrs. Aikman D.T.E. 02-24/25	Estimated Net Salv. % D.T.E. 98-51	Estimated Net Salv. % Aikman DTE 02-24/25
Prod.				
305	50	40	-15	-10
311	35	35	0	7
T & D				
366	50	50	-15	-15
367	65	65	-80	-120
380	45	45	-100	-150

Compare Exh. FGE-JHA-1, Sch. JHA-1 at [104-107] with D.T.E. 98-51 at 79, 80, 83-86. As this chart demonstrates, the variances between Mr. Aikman's estimates and the Department's findings in the last case are not significant, and in many cases the average service life estimates are the same. See, e.g., Account Nos. 311, 366, 367 and 380. The accounts listed on this table represent 84% of FG&E's total depreciable gas plant at December 31, 2001.

C. Aikman's Net Salvage Estimates are Reasonable

The Attorney General misses the point of Mr. Aikman's net salvage estimates and analysis. AG Reply Br. at 30. As explained in FG&E's initial brief, unlike the average life estimates, the electric net salvage estimates are based upon changes in recent years in the costs of environmental-related disposal. FG&E Br. at 163. The evidence of the increased costs of disposal is not in controversy and was appropriately relied upon by Mr. Aikman in his analysis.

Furthermore, the net salvage estimates of the currently authorized electric plant accrual rates are almost 20 years old. Clearly, disposal costs have increased since 1983, resulting in lower net salvage estimates in Mr. Aikman's 2001 study.

The Attorney General's recalculation of the average service lives based upon FG&E's use of the FIFO methodology should be rejected. AG Reply Br. at 31-32. FIFO is a recognized accounting methodology that FG&E applies consistently for pricing out retirements. See Tr. 8/6/02 (Vol. 2) at 179-181. Moreover, FG&E has no plans to change to a different method. Finally, in the last gas rate case, the Department allowed the FIFO methodology in the calculation of net salvage estimates as reasonable. See DTE 98-51 at 85.

VII. CONCLUSION

Wherefore, for all the reasons set forth in its Initial Brief and in this Reply Brief, Fitchburg Gas and Electric Light Company respectfully requests that the Department of Telecommunications and Energy grant its requests for rate relief pursuant to the evidence presented in this proceeding for its Electric Division and its Gas Division, and the schedules appended hereto.

Respectfully submitted,

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